Internal Revenue Service

memorandum

CC:TL-N-2395-91
Br2:CTSanderson

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to: District Counsel, New Orleans CC:NO
Attn: Arlene Blume

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This memorandum responds to your memorandum dated December 17, 1990, concerning the above-referenced case. You request our advice as to the litigating position which this office should take with respect to the issue set out below.

ISSUE

Whether, prior to the effective date of I.R.C. § 1503(e), discharge of indebtedness income which is excluded from a subsidiary's income under I.R.C. § 108(a) is to be added to the subsidiary's earnings and profits for purposes of computing the excess loss account under Treas. Reg. § 1.1502-19 when such inclusion in earnings and profits would effectively negate the intended application of the excess loss account recognition provisions of Treas. Reg. § 1.1502-19, thereby allowing excessive tax benefits to an affiliated group of corporations filing consolidated returns.

CONCLUSION

Service position, as expressed in G.C.M. 39303 and Wyman-Gordon Co. and Rome Industries, Inc. v. Commissioner, 89 T.C. 207 (1987), is that a subsidiary's earnings and profits should not be increased by discharge of indebtedness income that is excluded from the subsidiary's income under I.R.C. § 108(a) when the effect of such increase is to avoid the very recognition of the subsidiary's excess loss account contemplated by Treas. Reg. §§ 1502-19(a)(2)(ii)(b) and (b)(2)(iii), thereby allowing excessive tax benefits to an affiliated group of corporations filing consolidated returns. The holding in Wyman-Gordon is authority for the proposition that excluded discharge of indebtedness income should not increase earnings and profits to the extent such increase would eliminate the very recognition of income contemplated by Treas. Reg. §§ 1.1502-19(a)(2)(ii)(b) and (b)(2)(iii) absent a specific statute or consolidated return regulation requiring such increase. There is no statute or

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consolidated return regulation that specifically requires the increase in earnings and profits under the facts of this case. Accordingly, although there are litigation hazards in this regard, the above stated Service position remains the litigating position of the Service on this issue, and we would be willing to litigate the issue.

FACTS

[redacted], owns [redacted]% of the outstanding stock of [redacted]. [redacted] and [redacted] are part of a consolidated group that has filed consolidated returns since [redacted].

During the taxable year ended [redacted], [redacted] declared and was found to be bankrupt under Title 11. [redacted] owed a debt of $[redacted] to unrelated parties which was forgiven during the bankruptcy proceedings. The resulting discharge of indebtedness income was excluded under section 108.

As part of the bankruptcy, [redacted] sold all of its assets and distributed the proceeds to its creditors prior to the end of the taxable year ended [redacted]. [redacted] was not formally liquidated, however; it remains in existence today although it is presently inactive and has held no assets since the end of taxable year ended [redacted]. According to the appeals officer, taxpayer will probably keep [redacted] in existence for possible future use of the corporate entity.

According to the revenue agent's report, [redacted]'s excess loss account ("ELA") with respect to [redacted]'s stock was $[redacted] as of [redacted]. The agent's calculation of the ELA did not include the earnings and profits attributable to the $[redacted] discharge of indebtedness income to the extent such indebtedness exceeded the tax attributes reduced under section 108(b). The agent included the amount of recomputed ELA in [redacted]'s income for the year ended [redacted], due to the deemed disposition under section 1.1502-19(b)(2)(iii) discussed below.

Taxpayer maintains that the entire $[redacted] discharge of indebtedness income should be included in [redacted]'s earnings and profits ("E&P") for the year ended [redacted], even though it was not included in income due to section 108. As a result of this addition to E&P, taxpayer contends that it no longer had an ELA to be recognized under section 1.1502-19. Thus, the issue is whether E&P should be increased by the full amount of discharge income, as contended by taxpayer, or only to the extent tax attributes are reduced under section 108(b), as determined by the revenue agent.

DISCUSSION

G.C.M. 39303

The Service's position on this issue was discussed in G.C.M. 39303, which was issued on June 28, 1984. As pointed out in the G.C.M., it has long been established that forgiveness of indebtedness generally does not give rise to income if the debtor is insolvent. Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934); Treas. Reg. § 1.61-12(b). This rule was statutorily adopted when section 108 was amended by the Bankruptcy Tax Act of 1980. I.R.C. § 108(a)(1)(B). Only relatively recently, however, has the effect of such forgiveness on E&P been examined. G.C.M. 39303 stated the position that excluded discharge of indebtedness income should not be included in E&P when the effect of such inclusion is to avoid the very recognition of ELA contemplated by sections 1502-19(a)(2)(ii)(b) and (b)(2)(iii).

It is important to point out that the Service does not disagree that generally E&P does include discharge of indebtedness income even if it is excluded from taxable income because of the debtor's insolvency. In another context the Tax Court in Meyer v. Commissioner, 46 T.C. 65 (1966), rev'd, 383 F.2d 883 (8th Cir. 1967), agreed with the Service that forgiveness of an insolvent debtor's indebtedness increases the debtor's E&P to the extent the debtor does not decrease its basis in its assets under section 1017. The Tax Court reasoned that the forgiveness should increase E&P because, like tax-exempt income, the forgiveness of indebtedness income was realized income even if not recognized because of the debtor's insolvency. To the extent the taxpayer elected to reduce basis under section 1017, E&P would not be increased because a later sale would generally give rise to a corresponding E&P increase. Although the Eighth Circuit reversed the holding of the Tax Court, the Service has ruled that it will follow the Tax Court and not the Eighth Circuit in Meyer. Rev. Rul. 75-515, 1975-2 C.B. 117. The ruling's position was adopted in section 5(f) of the Bankruptcy Tax Act of 1980 by the addition of section 312(l)(1) to the Code, discussed below.

At issue in Meyer was whether excluded discharge of indebtedness income should be included in the debtor's E&P for the purpose of determining whether a distribution by the subsidiary is a dividend. At issue here, however, is the effect of this increased E&P when the debtor is a member of an affiliated group filing consolidated returns and when the increased E&P would defeat the purpose of the ELA recognition provision of section 1.1502-19(b)(2)(iii). The issue arises because section 1.1502-32(b)(1)(i) provides that an owning member's basis in the stock of its subsidiary is adjusted by the subsidiary's undistributed E&P. If the owning member has an ELA with respect to the stock, the undistributed E&P is applied to reduce the ELA. Treas. Reg. § 1.1502-32(e)(2).

The amount of the ELA is significant because section 1.1502-19(a)(1) provides in part that, immediately before the disposition of stock of a subsidiary, there shall be included in the income of each member disposing of such stock that member's ELA with respect to the stock disposed of. There are various deemed disposition events that trigger the recognition of ELA. The deemed disposition event relevant to these facts is described in section 1.1502-19(b)(2)(iii), under which a member shall be considered as having disposed of all its shares of stock in a subsidiary "[o]n the last day of each taxable year of such subsidiary ... in which an indebtedness of the subsidiary is discharged if such discharge would have resulted in 'cancellation of indebtedness income' <u>but for</u> the insolvency of the subsidiary." (Emphasis added.)

This "but for" condition is satisfied here because under section 108 [redacted] is able to exclude discharge of indebtedness income from its gross income due to its insolvency. Consequently, [redacted] is considered under section 1.1502-19(b)(2)(iii) as having disposed of all its [redacted] stock on the last day of the subsidiary's taxable year ended [redacted], the year [redacted]'s debt was forgiven. Any ELA with respect to [redacted] stock was then triggered, that is, taken into income immediately before the disposition. Treas. Reg. § 1.1502-19(a).

Taxpayer contends that the strict application of the investment adjustment rules under section 1.1502-32 results in the entire $[redacted] forgiveness of indebtedness income increasing [redacted]'s E&P by $[redacted]. The taxpayer also contends that the investment adjustment rules require a positive adjustment to [redacted]'s basis in [redacted] stock. This, according to the taxpayer, eliminated [redacted]'s ELA in [redacted]. Consequently, the triggering event under section 1.1502-19(b)(2)(iii) was irrelevant, because at the end of the year there was no existing ELA. The revenue agent on the other hand determined that earnings and profits are increased, and ELA reduced, by discharge of indebtedness income only to the extent of tax attributes reduced under section 108(b).

G.C.M. 39303 stated that the taxpayer's argument above, if correct, would defeat the very purpose of sections 1.1502-19(a)(2)(ii)(b) and (b)(2)(iii). As noted above, the forgiveness of a member's indebtedness that would give rise to income but for insolvency will trigger an owning member's ELA with respect to that debtor member. Treas. Reg. § 1.1502-19(b)(2)(iii). The character of that income will be capital unless the subsidiary is insolvent, in which case the character of the income is ordinary. Treas. Reg. § 1.1502-19(a)(2).

Treas. Reg. § 1.1502-19(a)(2)(ii) provides in part:

> If, at the time of the disposition of stock of a subsidiary, the subsidiary is insolvent, then the amount included in income under [Treas. Reg. § 1.1502-19(a)(1)] ... for any consolidated return year, shall be treated as ordinary income to the extent of such insolvency. For purposes of the preceding sentence, a subsidiary is insolvent to the extent that the sum of --
>
> (a) All its liabilities,
>
> (b) <u>All its liabilities which were discharged during consolidated return years to the extent such discharge would have resulted in "cancellation of indebtedness income" but for the insolvency of such subsidiary</u>, and
>
> (c) The amount to which all stock of such subsidiary which is limited and preferred as to dividends is entitled in liquidation, exceeds the fair market value of such subsidiary's assets. This subdivision shall not apply to the extent that the taxpayer establishes to the satisfaction of the Commissioner that the ordinary income portion of the excess loss account is attributable to losses of the subsidiary which reduced long-term capital gains of the group (without regard to section 1201).

(Emphasis added.)

Sections 1.1502-19(a)(2)(ii)(b) and (b)(2)(iii) are designed to work in tandem. The latter makes discharge of indebtedness during insolvency an ELA triggering event; the former characterizes as ordinary income a portion of the ELA equal to the amount of the discharged indebtedness that did not result in income to the debtor because of the insolvency. Thus, the triggering event -- the insolvency discharge -- is also a measure of the ordinary income. G.C.M. 39303 stated the view that the purpose of these provisions is self-evident: to require the member owning the insolvent subsidiary to report as ordinary income an amount equal to the ordinary income avoided by the subsidiary because of its insolvency, on the assumption that much of the ELA represents ordinary losses deducted on the consolidated return attributable to the subsidiary's discharged indebtedness. (If the taxpayer can satisfy the Commissioner that the losses reduced long-term capital gains of the group, the character of the income will be capital instead of ordinary. Treas. Reg. § 1.1502-19(a)(2)(ii), quoted above.)

This analysis is supported by a leading commentator. F. Peel, Jr. Consolidated Tax Returns § 15.03a, at 241 (2d ed. 1973), states:

> Ordinary income treatment is provided for excess loss accounts in insolvency cases because insolvency results in avoidance of ordinary income on the cancellation of indebtedness. Put another way, the argument that income from excess loss accounts should be capital gain because selling the assets of the subsidiary would produce capital gain loses its validity to the extent the subsidiary is insolvent; with the rationale for capital treatment gone the Regulations treat the excess loss account as ordinary income on the premise that the losses of the subsidiary probably were used to offset ordinary income of other members of the group.

If taxpayer's position in this case were accepted, it would subvert the characterization rule in section 1.1502-19(a)(2)(ii)(b) and frustrate the purpose of having insolvency discharge be an ELA triggering event. This is because under taxpayer's approach the investment adjustment under sections 1.1502-32(b)(1)(i) and (e)(2) would eliminate precisely the portion of the ELA that section 1.1502-19(a)(2)(ii)(b) contemplates will be taxed as ordinary income. If taxpayer's adjustment eliminated the ELA entirely, nothing would be taken into income.

Wyman-Gordon

This very same issue was considered by the Tax Court in Wyman-Gordon Co. and Rome Industries, Inc. v. Commissioner, 89 T.C. 207 (1987), in connection with a 1978 transaction. The Service made the argument expressed in G.C.M. 39303.

The Tax Court in Wyman-Gordon stated the issue as whether the discharge income realized by the subsidiary increased E&P even though the discharge income is not included in consolidated taxable income. The court saw the issue as turning on whether discharge income may be included in E&P even though excluded from income where the inclusion in E&P would effectively allow an affiliated group of corporations excessive tax benefits by avoiding recognition of an ELA balance.

In Wyman-Gordon, as here, taxpayer argued that it is the rule that discharge of indebtedness income is included in E&P even though it is excluded from taxable income and even though such inclusion in E&P would effectively allow an affiliated group of corporations excessive tax benefits by avoiding recognition of an ELA balance. The court, however, agreed with the respondent that "no such rule exists, that the result sought by petitioners is contrary to the overriding policy of the consolidated return regulations to prevent the avoidance of tax liability, and that such result is not required by the Code or the regulations governing the computation of earnings and profits." Wyman-Gordon, supra at 216. The court also agreed with respondent "that the policies underlying the regulations applicable to excess loss accounts would be subverted if petitioners' position is adopted." Id.

In stating its rationale for agreeing with respondent, the court noted the "strong policy against allowing double deductions in the context of consolidated tax returns." Id. at 217. But more important, the court recognized the specific purpose of section 1502-19:

> . . . [T]he regulations under section 1502 expressly provide that upon "disposition" of the stock of a subsidiary, the parent corporation is required to recognize as income the balance of the excess loss account with respect to its subsidiary's stock. Furthermore, section 1.1502-19(b)(2), Income Tax Regs., expressly provides that the realization of discharge of indebtedness income where such income is not included in taxable income constitutes a "disposition" event and triggers recognition of the excess loss account. . . .

Id.

The court also noted that, although the ELA generally will be included in taxable income as capital gain, if "at the time of the disposition event the subsidiary is insolvent . . . the balance of the excess loss account will be included in taxable income as ordinary income." The court, as did G.C.M. 39303, used the above quoted excerpt from Peel in stating the policy underlying this rule. Id. at 218.

The court then concluded:

> In light of the specific rules under section 1.1502-19, Income Tax Regs., governing the recognition of an excess loss account in taxable income immediately before specified disposition events, and in light of the objectives and policies of those rules, we are hesitant to make (and it would require clear and explicit authority to support) a finding herein that

would allow taxpayers to avoid the intended application of those rules.

Id. (emphasis added).

The court said it could not find "any specific provisions that would allow discharge of indebtedness income that is not included in taxable income to offset or to eliminate the very recognition of income contemplated by section 1.1502-19." Id. at 219.

Thus, it is significant that the court did not conclude that discharge income was not included in E&P for any purposes; instead, the court only concluded that excluded discharge income should not be allowed "to offset or to eliminate the very recognition of income contemplated by section 1.1502-19." Id.

The court next distinguished Woods Investment Co. v. Commissioner, 85 T.C. 274 (1985), relied on by petitioners. In Woods Investment Co., the court held that under section 1.1502-32 a subsidiary corporation within an affiliated group could compute E&P utilizing straight-line depreciation, even though in doing so the subsidiary would benefit from a double deduction because it had utilized an accelerated method of depreciation to compute its taxable income. The Wyman-Gordon court distinguished its Woods Investment Co. holding on the basis that it "was based in large part on section 312(k), which specifically requires a corporation to compute earnings and profits on the basis of straight-line depreciation. There exists no comparable statutory provision that requires inclusion of discharge of indebtedness income in earnings and profits in the situation before us . . ." Wyman-Gordon, supra at 219 (emphasis added).

The Wyman-Gordon court also distinguished Rev. Rul. 75-515, supra, and Meyer v. Commissioner, supra, discussed above. Although both Rev. Rul. 75-515 and Meyer concluded that E&P was increased by nontaxable discharge of indebtedness income in computing taxable dividends, "[n]either excess loss accounts nor basis adjustments under the consolidated return provisions were involved." Wyman-Gordon, supra at 220. The court again focused on the "strong policy against the allowance of double deductions within the context of consolidated income tax returns" and concluded that the "duplicate or excessive tax losses and deductions arising out of the operations and insolvency of one subsidiary distinguish our holding in Meyer and respondent's position in Rev. Rul. 75-515, and justify our adoption of a different rule in the context of the recognition of a corporation's excess loss account." Wyman-Gordon, supra at 220-21.

Although the court's stated rationale for distinguishing Rev. Rul. 75-515 and Meyer arguably is weak, the point that the court made earlier remains compelling: excluded discharge of indebtedness income should not be included in E&P for purposes of determining the ELA balance since such inclusion would negate the very purpose of section 1.1502-19 (a legislative regulation) in requiring the recognition of ELA as ordinary income when there is discharge income that is excluded from taxable income because of the debtor subsidiary's insolvency. The Tax Court obviously believes that section 1.1502-19's purpose should not be defeated absent a "statutory provision that [specifically] requires inclusion of discharge of indebtedness income in earnings and profits" under the Wyman-Gordon facts. Wyman-Gordon, supra at 219.

It is our position that there is no statutory provision that specifically requires inclusion of discharge of indebtedness income in E&P under these facts. See Southern California Savings and Loan Association, et al. v. Commissioner, 95 T.C. No. 3 (July 5, 1990) (court held that section 1.502-76(b)(4) excluded application of section 461(e)). As pointed out above, the Service does not contest that as a general matter discharge of indebtedness income is included in E&P even if it is excluded from income because of the debtor's insolvency. This general rule is required by section 312(l)(1), discussed below.[1] The Service's position, as expressed in G.C.M. 39303 and in Wyman-Gordon, is that, despite the above general rule, excluded discharge of indebtedness income should not be included in E&P for purposes of determining the ELA balance when such inclusion would have the effect of negating the purpose of section 1.1502-19, thereby allowing excessive tax benefits to an affiliated group of corporations filing consolidated returns.

Section 312(l)(1)

Although section 312(l)(1), a Bankruptcy Tax Act of 1980 provision, was enacted after the transactions at issue in Wyman-Gordon, the court was called on to explain why the enactment of the provision did not support the petitioners' position. The court recognized that the "legislative history [of section 312(l)(1)] makes it clear that discharge of indebtedness income, including amounts excluded from taxable income due to the debtor's insolvency, will increase earnings and profits (or reduce a deficit in earnings and profits) to the extent the taxpayer's basis in depreciable assets is not reduced." Wyman-Gordon, supra at 221. The court was of the view, however, that the "significance of the addition of section 312(l) . . . cannot be understood without considering important amendments to section

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[1] Section 312(l)(1) provides: "(1). . . The earnings and profits of a corporation shall not include income from the discharge of indebtedness to the extent of the amount applied to reduce basis under section 1017."

108 that also were made by the Bankruptcy Tax Act of 1980." Wyman-Gordon, supra at 222.

After noting that under section 108(b), also enacted in the Bankruptcy Tax Act of 1980, "a taxpayer who under section 312(l) excludes discharge of indebtedness income from taxable income due to insolvency and does not elect to reduce basis in depreciable assets under section 1017, must reduce certain other tax attributes," the court said:

> Thus, under amended sections 108 and 312(l), if these provisions were applicable to petitioners in 1978, Woods & Copeland would be entitled to exclude the $2,038,161 discharge of indebtedness from its taxable income, and it would be entitled to increase its earnings and profits (and thereby reduce its excess loss account) by the amount of the discharge of indebtedness income. However, and particularly significant to our analysis herein, section 108(b) would require Woods & Copeland to reduce its net operating losses, which would increase consolidated taxable income of the affiliated group of corporations, thereby eliminating most of the duplicate deductions or excessive loss characteristics of the instant transaction.13

Wyman-Gordon, supra at 222-23 (footnote 13 is discussed below).

The court went on to conclude that "[w]ithout a clear mandate in the Code or regulations requiring a contrary interpretation, we adopt herein an interpretation of the pertinent provisions of sections 1.1502-19 and 1.1502-32 . . . that accomplishes a similar result with regard to years prior to the effective date of the 1980 legislation." Id. at 223. What the court seemed to really be doing, however, was again focusing on the overriding purpose of section 1.1502-19(b)(2)(iii) in providing that discharge of indebtedness during insolvency is an ELA triggering event. Since a reduction of tax attributes under section 108(b) effectively requires a recognition of income by the group equal to the tax attributes reduced, the court presumably recognized that the purpose of section 1.1502-19(b)(2)(iii) would not be negated by the increase in E&P due to discharge income to the extent tax attributes were reduced under section 108(b). Since tax attributes were not reduced under section 108(b) prior to 1980, however, the purpose of section 1.1502-19(b)(2)(iii) was achieved only by denying any E&P increase for excluded discharge income.

In the present case section 108(b) does apply and tax attributes are reduced. Thus, the purpose of section 1.1502-19(b)(2)(iii) is not negated by increasing E&P for discharge income to the extent of the tax attributes reduced. However, the purpose is negated if E&P is increased, and ELA reduced, to the extent the discharge income exceeds the reduced tax attributes.

Wyman-Gordon Dicta in Footnote 13

Since Wyman-Gordon has never been reversed, it remains good law. See Rev. Rul. 89-85, 1989-2 C.B. 218, where, although in another context, the Service cited Wyman-Gordon in stating that "there is a strong policy in favor of construing the consolidated return regulations in a manner consistent with their underlying purposes." However, dicta in Wyman-Gordon itself presents some ligation hazards under the facts presented in this case.

After the explanation by the court discussed above that sections 108 and 312(l) work in tandem to "eliminate[] a significant part of the potential tax mischief inherent in the rule" that "nontaxable discharge of indebtedness income is includable in earnings and profits," the court said in a footnote:

> 13 If the 1978 operating losses of Woods & Copeland that would be reduced under sec. 108(b) (if that section were in effect for 1978) were less than the discharge of indebtedness income included in earnings and profits, sec. 108(b) would then require adjustments to Woods & Copeland's claimed general business credits under sec. 38, to its claimed capital loss carryover under sec. 1212, to the basis in its property (or to the basis of that property in the hands of Wyman-Gordon as the transferee thereof), or to its foreign tax credit carryovers. Sec. 108(b). Obviously, Woods & Copeland's discharge of indebtedness income would increase its earnings and profits without a corresponding effect on Woods & Copeland's other tax attributes to the extent the discharge of indebtedness income exceeds the tax attributes to be adjusted under sec. 108(b). . . .

Wyman-Gordon, supra at 223, n. 13.

It is not disputed that the calculation of the ELA should include E&P from discharge of indebtedness income to the extent of tax attributes reduced under section 108(b). It is any excess discharge of indebtedness income, i.e., income in excess of tax attributes reduced under section 108(b), that is at issue in this case. It could be argued that the dicta above supports a conclusion that any such excess discharge of indebtedness income should be included in E&P even for the purpose of determining an ELA balance and even if the effect of such inclusion defeats the purpose of section 1.1502-19.

However, the footnote is merely dicta. The court was not faced with the situation that exists here where the discharge of indebtedness income exceeds the tax attributes reduced under section 108(b). The inclusion in E&P of this excess discharge income would defeat the very purpose of sections 1.1502-19(a)(2)(ii)(b) and (b)(2)(iii). The overriding conclusion of the Wyman-Gordon opinion remains that there is no specific statutory provision or regulation that requires that the purpose of these sections be defeated by including discharge of indebtedness income in E&P for purposes of computing an ELA balance in such a way that allows excessive tax benefits to an affiliated group of corporations filing consolidated returns.

Section 1503(e)

Congress addressed this very issue in 1987 when it enacted section 1503(e). Section 1503(e) applies to any "intragroup stock" disposed of after 12-15-87 and provides in relevant part:

> (e) Special Rule for Determining Adjustments to Basis-- (1) In general.--Solely for purposes of determining gain or loss on the disposition of intragroup stock and the amount of any inclusion by reason of an excess loss account, in determining the adjustments to the basis for such intragroup stock on account of the earnings and profits of any member of an affiliated group for any consolidated year (and in determining the amount in such account) --
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> * * *
>
> (B) earnings and profits shall not include any amount excluded from gross income under section 108 to the extent the amount so excluded was not applied to reduce tax attributes (other than basis in property).

Under Section 1503(e)(1)(B), earnings and profits are increased by excluded discharge income only to the extent that tax attributes (other than basis in property) are reduced under section 108(b). This provision "clarified that the upward adjustment for cancellation of indebtedness income cannot exceed the amount of the tax attribute that was reduced." See H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. 19 (1988). Section 1503(e) applies to "any transaction or event that is treated as a disposition of the stock of the subsidiary under the consolidated return regulations, whether or not there is an actual disposition." H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 962-63 (1987).

As stated, section 1503(e) applies only to dispositions after 12-15-87, which would generally preclude its application to this case. Arguably the enactment of section 1503(e) in 1987 precludes the Service from denying, in pre-enactment cases, a full inclusion in E&P of discharge income. Such a position by the Service could be seen as an attempt to apply section 1503(e) retroactively. Also, arguably there would have been no need for section 1503(e) if under prior law the same result was already reached.

Despite the inevitability of these arguments, however, the legislative history of section 1503(e) seems clear that Congress was clarifying, not necessarily changing, the law with respect to the effect on E&P of discharge of indebtedness income, and intended no inference as to prior law in this regard.[2] See H.R. Conf. Rep., supra; Senate Comm. on Finance, 100th Cong., 1st Sess., Explanation of Provisions Approved by the Committee on December 3, 1987 For Inclusion in Leadership Deficit Reduction Amendment 158 (Comm. Print 1987). As such, the enactment of section 1503(e) does not prevent the Service from taking the same position that it took in Wyman-Gordon.

Special Rule for Dispositions on or before 12-16-87

As pointed out above, section 1503(e) applies only to dispositions after 12-15-87. However, a special provision for dispositions on or before 12-16-87 is contained in the legislation enacting section 1503(e). It provides:

(C) Treatment of certain excess loss accounts.--

(i) In general.--If--

(I) any disposition on or before December 15, 1987, of stock resulted in an inclusion of an excess loss account (or would have so resulted if the amendments made by paragraph (1) had applied to such disposition), and

(II) there is an unrecaptured amount with respect to such disposition,

the portion of such unrecaptured amount allocable to stock disposed of in a disposition to which the amendment made by paragraph (1) applies shall be taken into account as negative basis. To the extent permitted by the Secretary of the Treasury or his delegate, the preceding sentence shall not apply to the extent the taxpayer elects to reduce its basis in indebtedness of

[2]In contrast, Congress was clearly "overruling" Woods Investment Co., supra, in enacting section 1503(e). S. Rep. No. 445, 100th Cong., 2d Sess. 430 (1988); H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. 239 (1988).

the corporation with respect to which there would have been an excess loss account.

(ii) Special rules.--For purposes of this subparagraph--

(I) Unrecaptured amount.--The term "unrecaptured amount" means the amount by which the inclusion referred to in clause (i)(I) would have been increased if the amendment made by paragraph (1) had applied to the disposition. . . .

The "paragraph (1)" referred to in this special rule is paragraph (1) of section 10222(a) of the 1987 Omnibus Budget Reconciliation Act which added section 1503(e). Paragraph (2)(A) of the same section provides the effective date of section 1503(e), i.e., it applies "to any intragroup stock disposed of after 12-15-87." However, paragraph (2)(A) further states: "For purposes of determining the adjustments to the basis of such stock, such amendment shall be deemed to have been [in] effect for all periods whether before, on, or after 12-15-87." Paragraph (2)(C)[3] (quoted above) then goes on to provide a basis adjustment rule for pre-December 16, 1987, dispositions.

The special rule for pre-December 16, 1987, dispositions is explained in the legislative history of the 1988 technical corrections to section 1503(e):

> The bill provides that if an excess loss account disposition event was not subject to the act, any remaining stock, when disposed of, will be treated as having a negative basis equal to the portion allocable to such stock of the unrecaptured amount that would have been the excess loss account if a prior disposition had been subject to the Act. To the extent permitted by regulations, in lieu of such immediate gain recognition the taxpayer may elect to reduce its basis in indebtedness of the corporation with respect to which there would have been an excess loss account if the earlier disposition had been subject to the Act. The provision is intended to permit the Treasury Department to provide relief to taxpayers that would have been eligible to elect to reduce the basis of the debt under Treasury Regulations section 1.1502-19(a)(6) if the original disposition had been subject to the Act. [No regulations under this special rule have been promulgated.]

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[3] Paragraph (2)(B) provides a transitional rule for certain post-December 15, 1987, dispositions that had been commenced, but not completed, on or before 12-15-87. There are no other paragraphs under section 10222(a).

S. Rep. No. 445, 100th Cong., 2d Sess. 431 (1988) (emphasis added).

This special rule presents the strongest argument for not requiring recognition in taxable year ended [redacted], of the ELA at issue. Clearly this ELA would be recognized under section 1503(e)(1)(B) if it applied. Arguably the special rule provides the exclusive means for requiring taxpayer to recognize this ELA. Under the special rule, if it otherwise applies, the ELA would not be recognized in taxable year ended [redacted], but it would be "recaptured" if and when there is a subsequent disposition event after [redacted]. Thus, the ELA would be recognized, and the purpose of section 1.1502-19(b)(2)(iii) achieved, although on a deferred basis.

However, the special provision requires recapture only of amounts that were not required to be recognized under prior law. As discussed above, there remains a basis for the position that the ELA at issue should be recognized in the taxable year ended [redacted]. Thus, until it is decided whether the ELA at issue should be recognized under prior law, we cannot assume that such amount will be subject to recapture under the special provision.[4]

Potential Application of the Special Provision to this Case

Although the primary position of the Service in this case should be that the ELA at issue should be recognized in the taxable year ended [redacted], the potential application of the special provision above should be considered in the alternative. Since [redacted] is still in existence and there has been no activity concerning [redacted] or its stock since [redacted], it would seem at first blush that there has been no disposition event involving [redacted] since [redacted], including the period since [redacted]. However, according to the appeals officer, [redacted] has held no assets since [redacted]. Based on this, it may be that the stock in [redacted] was "wholly worthless within the meaning of section 165(g)" during the taxable year ended [redacted]. If so, this would be a disposition event under section 1.1502-19(b)(2)(iii) that occurred after [redacted], so as to arguably trigger the recapture requirement of the special provision.

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[4]A significant point to remember in this regard is that the special provision would still have potential application even if it did not apply to discharge of indebtedness cases such as this one. For example, it may apply to fact patterns covered by Woods Investment Co. discussed supra.

The appeals officer does not have the [redacted] year, and he told us that [redacted] is no longer under examination. Of course, depending on whether the ELA at issue should have been recognized in [redacted], there may not be any ELA to recapture in [redacted]. However, because of the possibility that there is ELA to be recaptured in [redacted] and because of the possibility that there was a disposition event in [redacted], we advise that you take whatever steps are necessary to have Examination or Appeals keep [redacted] open until [redacted] is resolved. We are available to assist you in providing assistance to Examination or Appeals in determining whether there was a disposition event in [redacted].

We also advise that you recommend to the appeals officer that if he settles the [redacted] year by allowing taxpayer to avoid recognizing a portion of the ELA, he should require the taxpayer to agree to recapture the unrecognized amount if and when there is a subsequent disposition event after [redacted]. If there was a disposition in [redacted] because [redacted] stock was worthless, the taxpayer should be required to recapture any unrecognized ELA in [redacted]. Again, we are available to assist you in providing assistance to Examination or Appeals in determining whether there was a disposition event in [redacted].

If the appeals officer is unable to settle the case and issues a statutory notice for [redacted], we may want to consider also issuing a notice for [redacted] raising the recapture of the ELA in [redacted] under the special provision as an alternative to the recognition of the ELA in [redacted] under Wyman-Gordon, provided it is determined that a disposition event occurred in [redacted]. This way, if the case ultimately goes to court, both years will be before the court and the court will have jurisdiction to determine the application of the special provision in [redacted] if it decides against the Service as to recognition in [redacted].

Summary

To summarize, the Service's position remains that excluded discharge of indebtedness income should not increase E&P for purposes of determining an ELA balance to the extent such increase would negate the purpose of sections 1.1502-19(a)(2)(ii)(b) and (b)(2)(iii) and result in excessive tax benefits to an affiliated group of corporations filing consolidated returns. Although there are certainly litigation hazards with this position, we would be willing to litigate the issue. Litigating the issue in this case could also serve to clarify the application of the special provision for pre-December 16, 1987, dispositions.

If you have any questions or need any further assistance, contact Ted Sanderson on (FTS) 566-3520.

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